

# Mortgage Credit and Sub-prime Lending: Implications of a Deflating Bubble

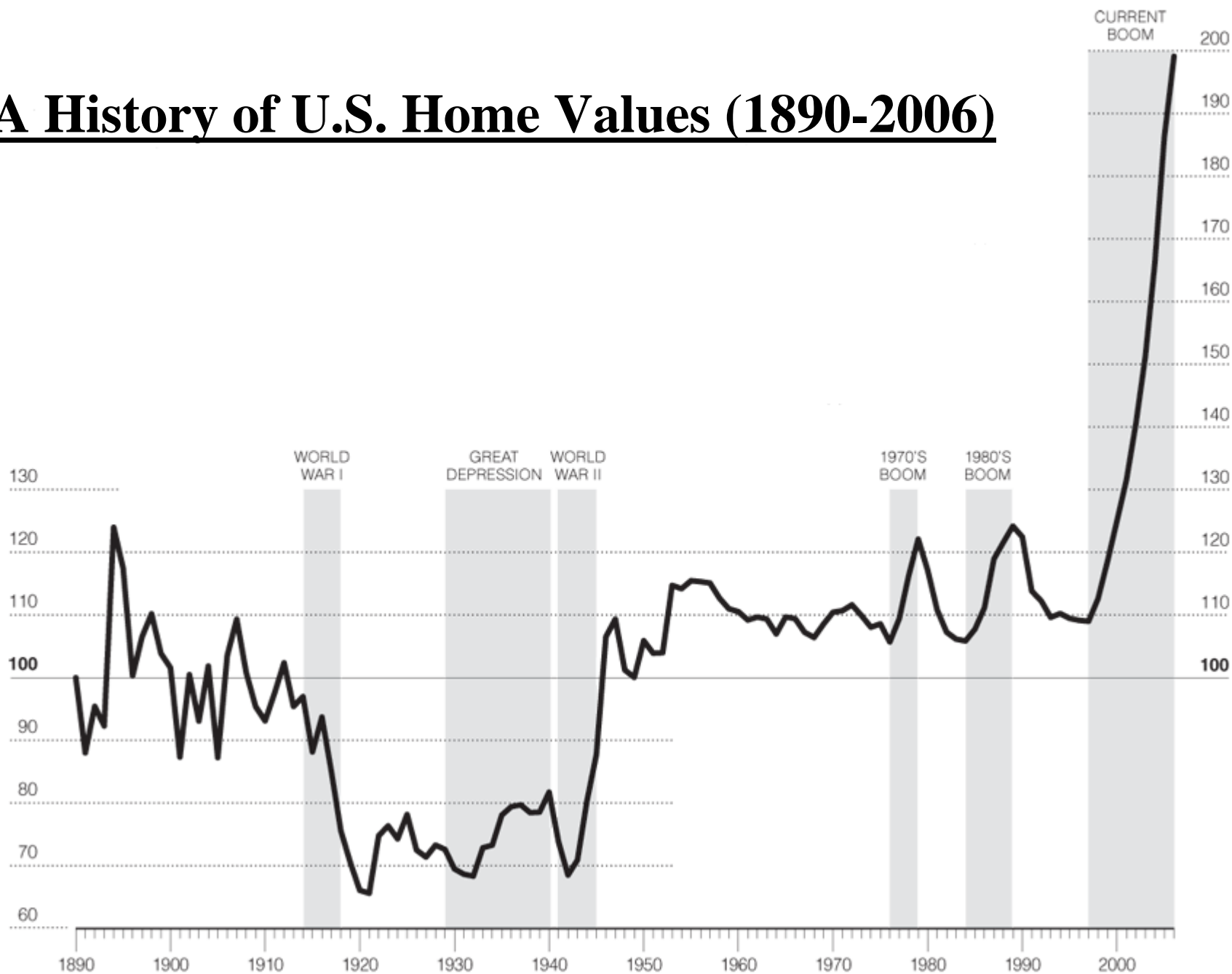
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## From Where Have We Come?

- Between 2000 and 2006 U.S. home prices increased by around 80 percent, an amount that has no precedent over the past 100 years
- Over the past five years, home ownership increased from its historic average of around 64 percent to almost 70 percent
- Sub-prime and Alt-A lending accounted for around 33 percent of total mortgage lending in 2006
- Investment home and vacation home purchases accounted for almost 40 percent of total home purchases in 2005
- The housing boom has raised household debt to record levels
- The housing boom has been accompanied by a dramatic decline in the ratio of savings to disposable income.

# A History of U.S. Home Values (1890-2006)

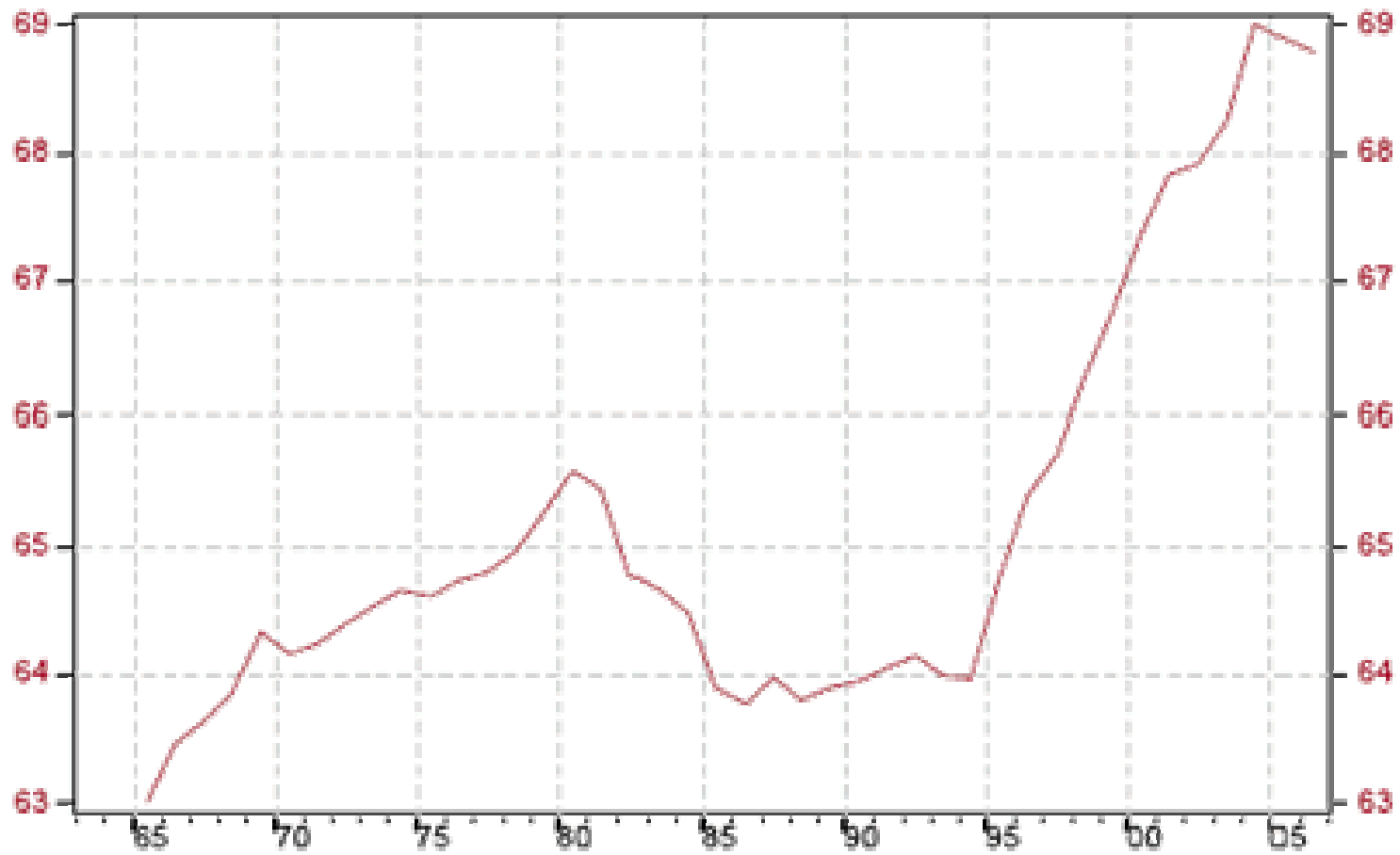


Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller

Bill Marsh/The New York Times

## Homeownership Rate: United States

NSA, %

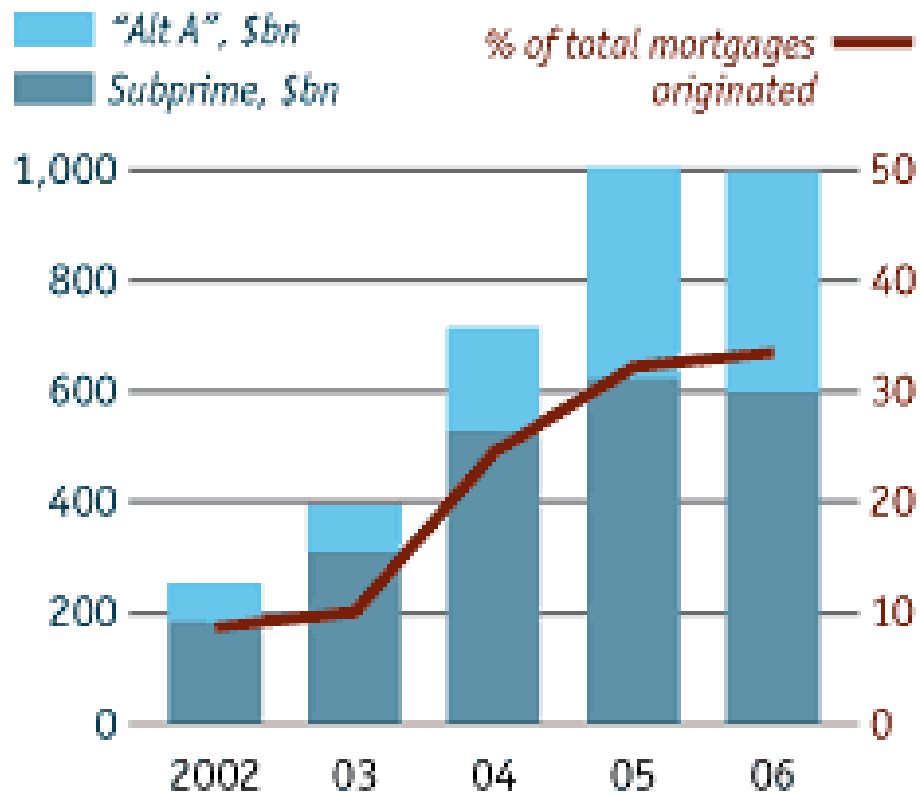


Source: Census Bureau /Haver Analytics

## A Confluence of Factors Fueled the Housing Bubble

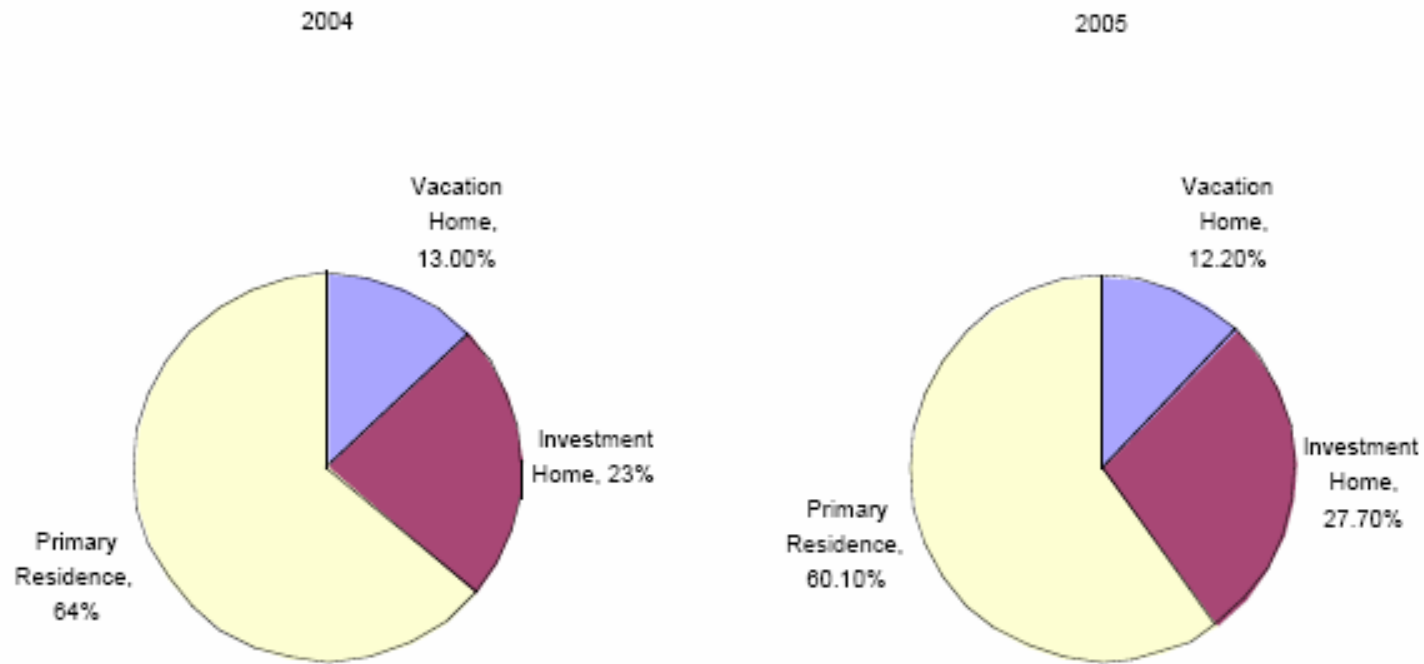
- In the wake of the bursting of the NASDAQ bubble, interest rates were reduced to 1 percent by 2003 and were maintained at abnormally low levels
- Credit standards were dramatically relaxed as sub-prime lending and Alt-A lending boomed
- Exotic lending instruments, like adjustable rate mortgages and negative amortization loans, mushroomed
- Speculative activity gathered pace

## SubPrime and "Alt-A" Mortgages



Source: *Inside Mortgage Finance*

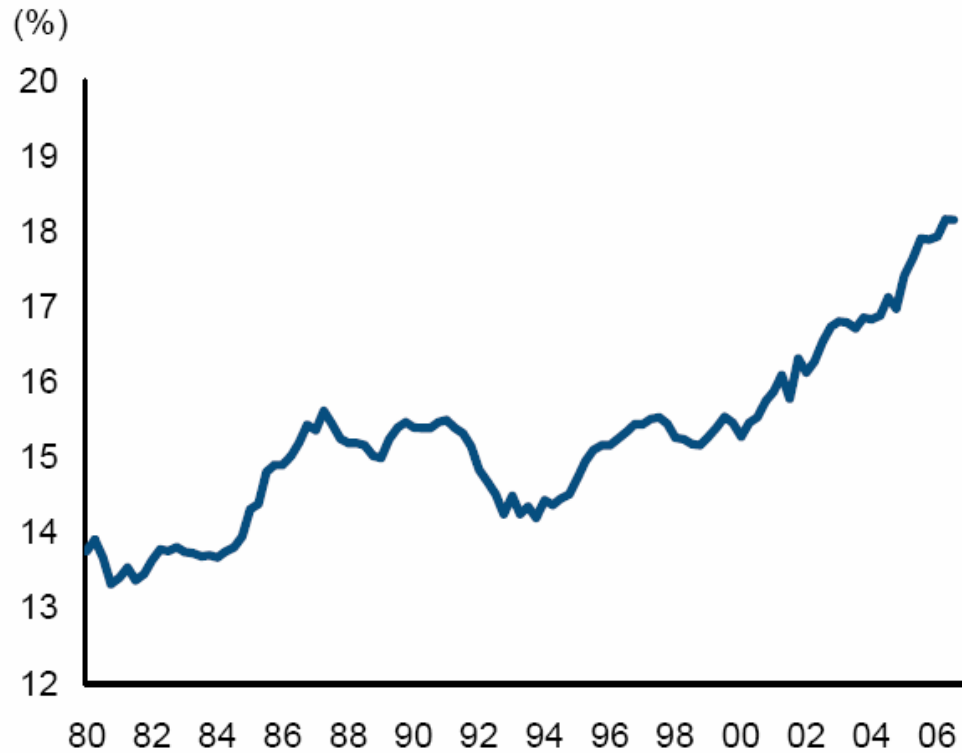
## INVESTMENT HOMES SHARE OF TOTAL HOMES PURCHASED



Source: National Association of Realtors

## Housing Boom Left Households with Big Debt Load

### Homeowners' Financial Obligation Ratio

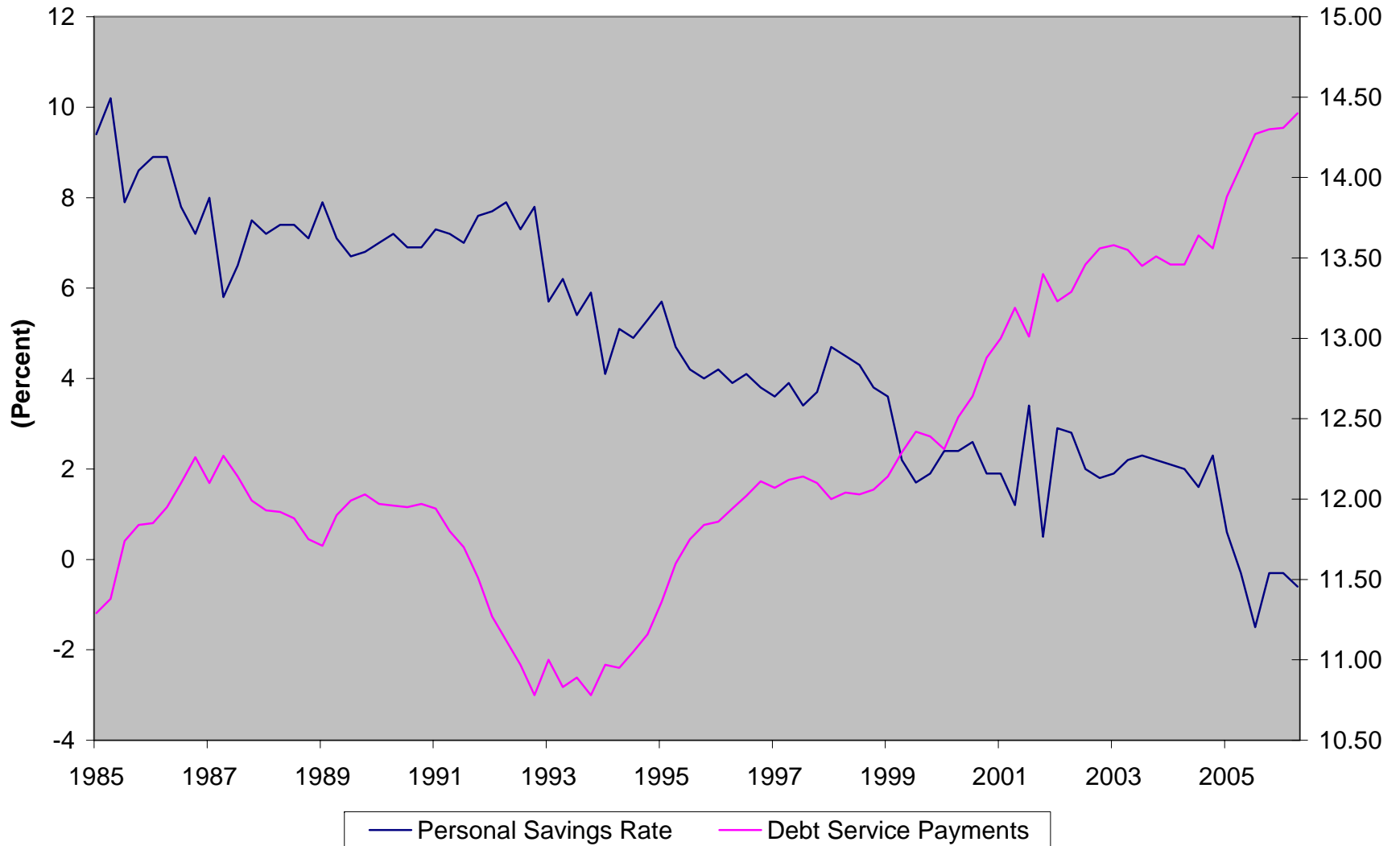


The financial obligation ratio is an estimate of the ratio of financial obligations to disposable personal income.

Source: Federal Reserve Board and Haver Analytics

# U.S. Household Savings and Debt Service Payments

## % of disposable personal income

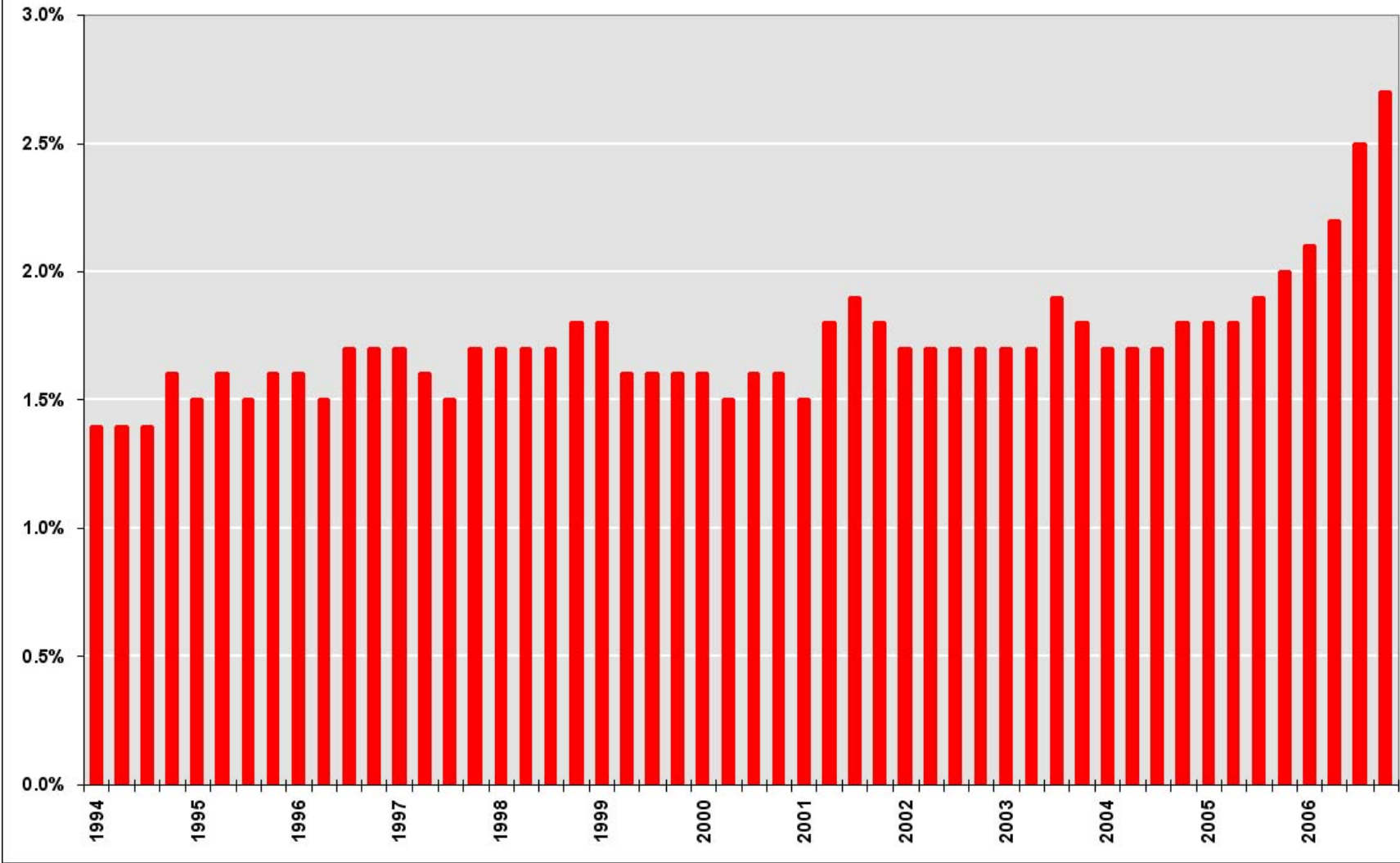


Source: Federal Reserve

## Where are we now?

- The housing market is characterized by substantial excess supply
- Homeowner vacancy rates have surged to record highs
- The supply of unsold houses has increased to over 7 months' supply
- Housing completions continue to outpace underlying demand thereby further adding to supply
- House prices have now begun to fall and cancellations have become commonplace
- Major problems have emerged in the sub-prime lending space even before the economy has turned down.

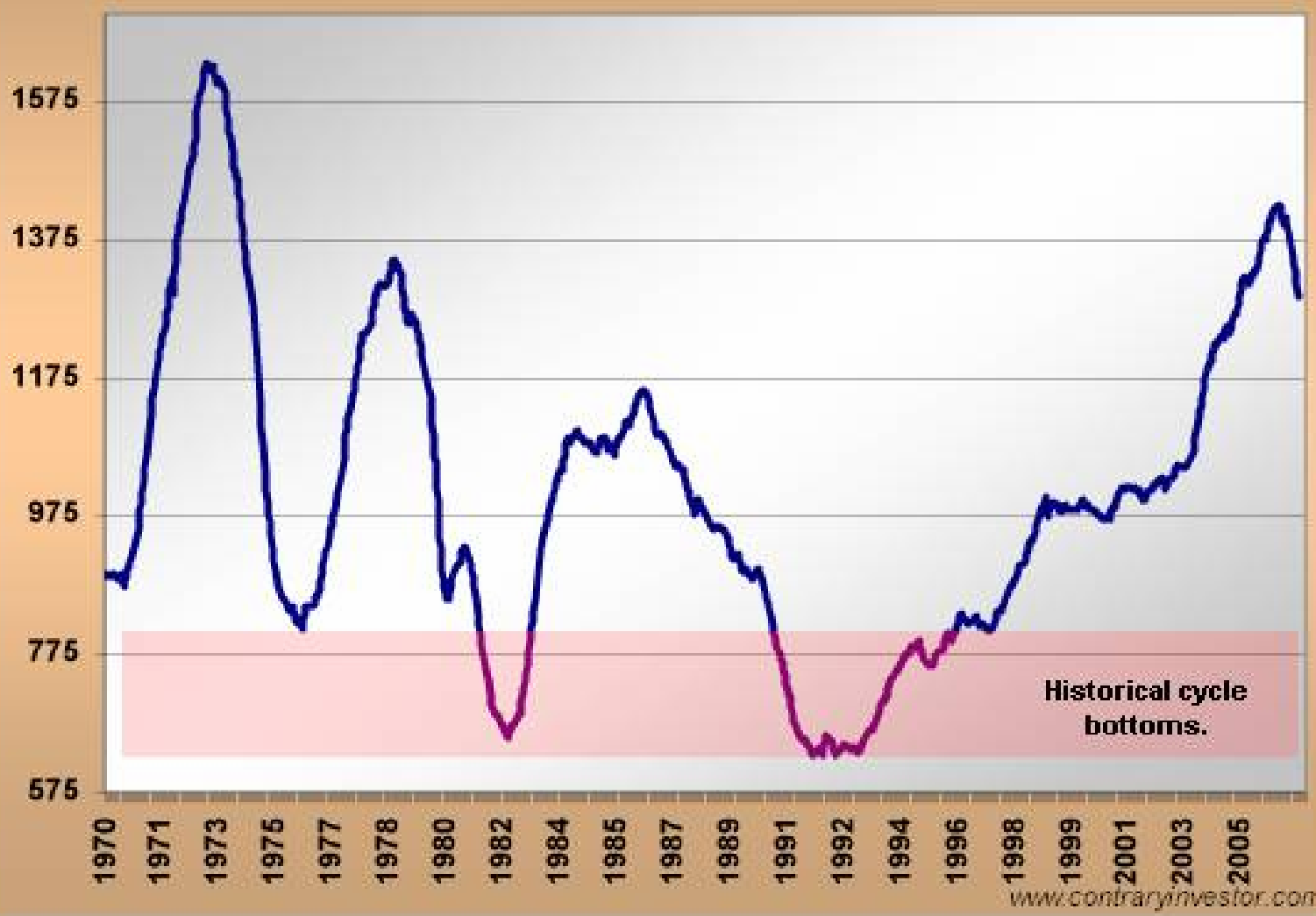
### Homeowner Vacancy Rate



## US Months Supply Of Houses At Current Sales Rates

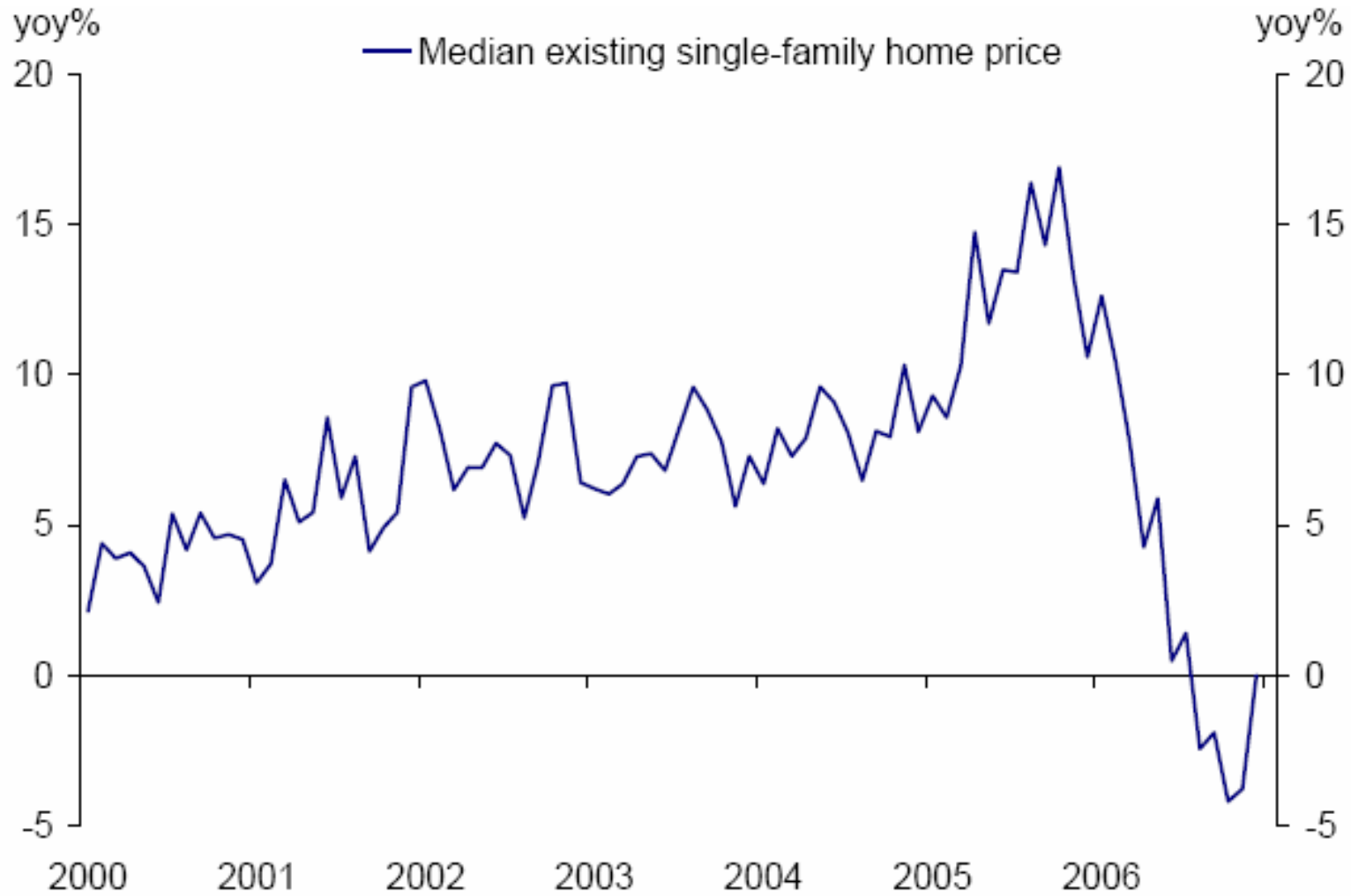


### New Homes Under Construction (000)



www.contraryinvestor.com

## Existing house prices are falling



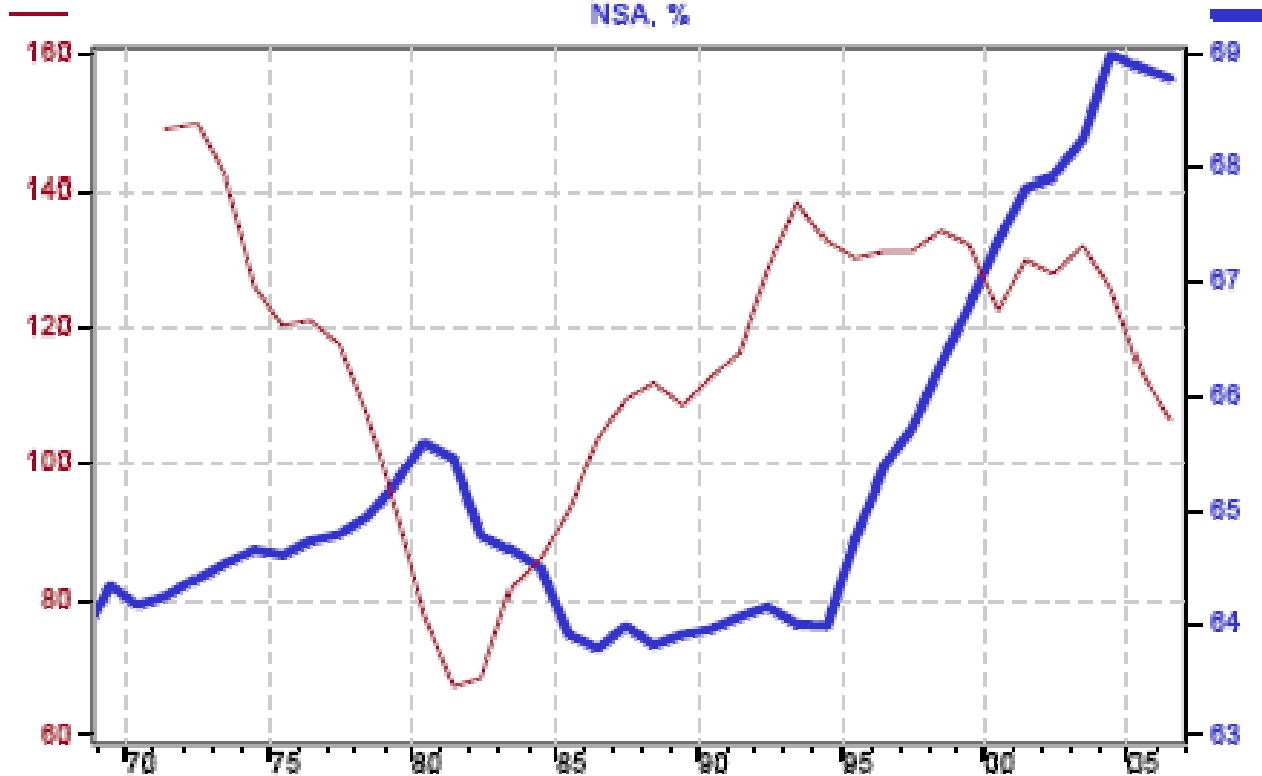
Source: FRB, DB Global Markets Research

## Where are we going?

- Demand for housing is drying up at a time of excess supply as the factors that fueled the boom go into reverse
- Federal Reserve has normalized interest rates at  $5\frac{1}{4}$  percent after a prolonged period of monetary policy accommodation
- Rising default rates in the sub-prime mortgage space have already resulted in the shutdown of 30 sub-prime mortgage lenders
- Mortgage lending standards are being tightened
- Foreclosed properties could result in more than 500,000 houses returning to the market in 2007
- Speculative positions are no longer supporting the market and these positions may start to be reversed

< Composite Housing Affordability Index  
Median Inc=Qualifying Inc=100

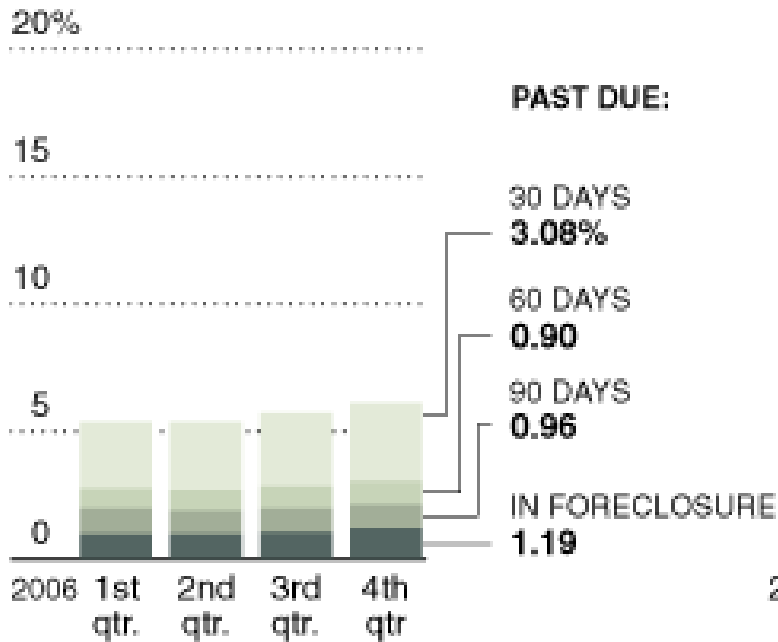
Homeownership Rate: United States >  
NSA, %



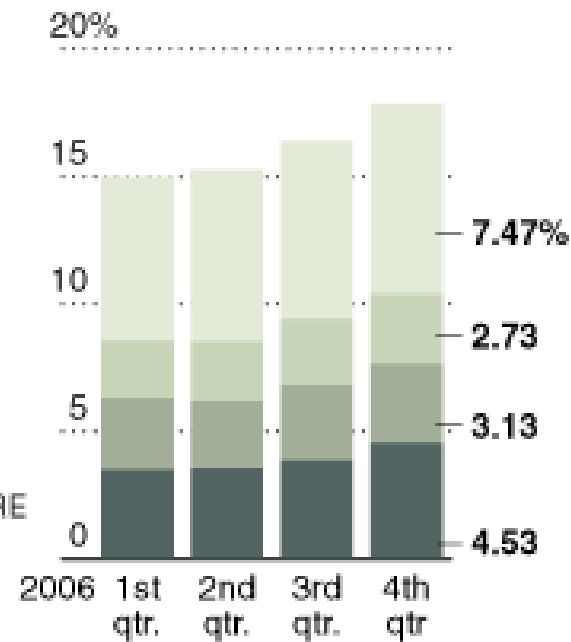
Sources: National Association of Realtors, Census Bureau /Haver Analytics

# Rising Delinquencies

**ALL HOME LOANS: 33,322,667**  
*As of 4th quarter; percentage figures are seasonally adjusted*



**SUBPRIME LOANS: 5,971,363**  
*As of 4th quarter; percentage figures are seasonally adjusted*

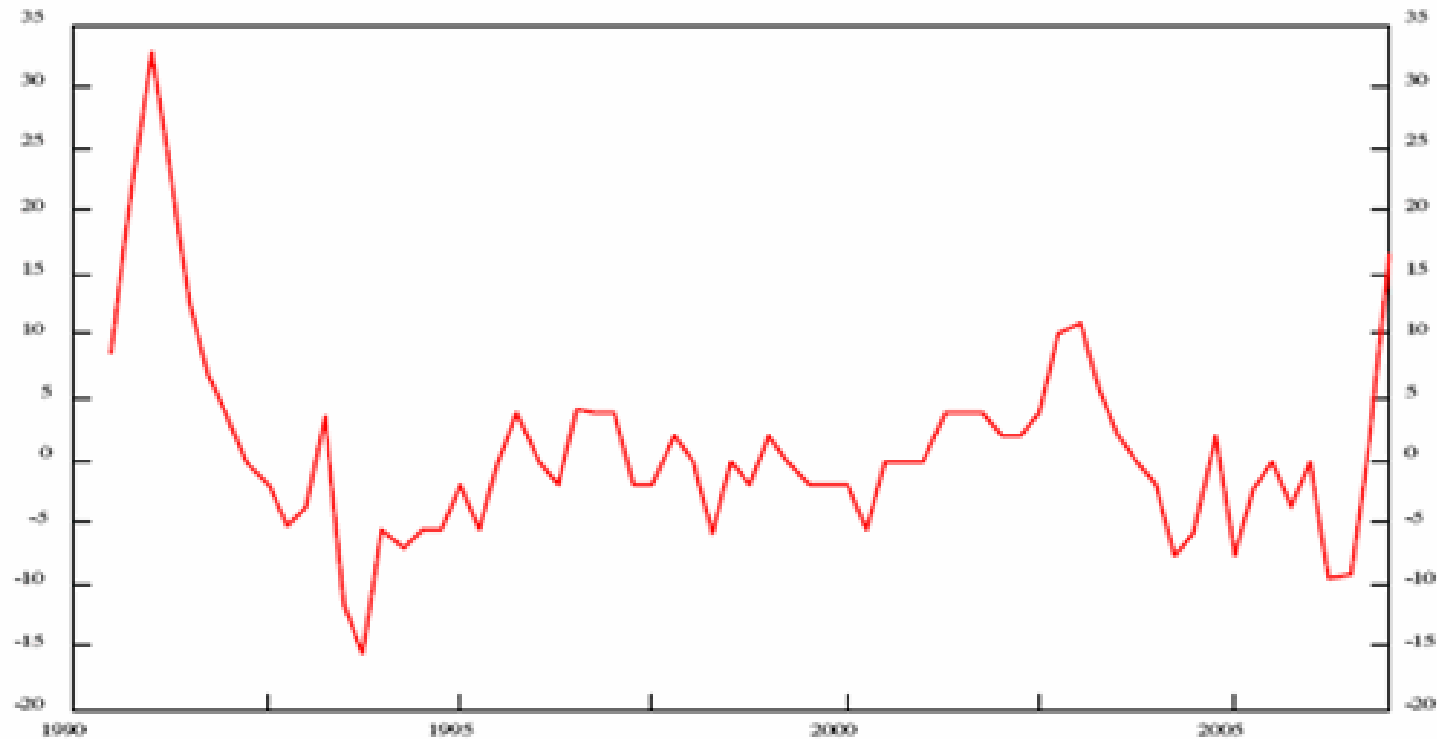


Source: Mortgage Bankers Association

The New York Times

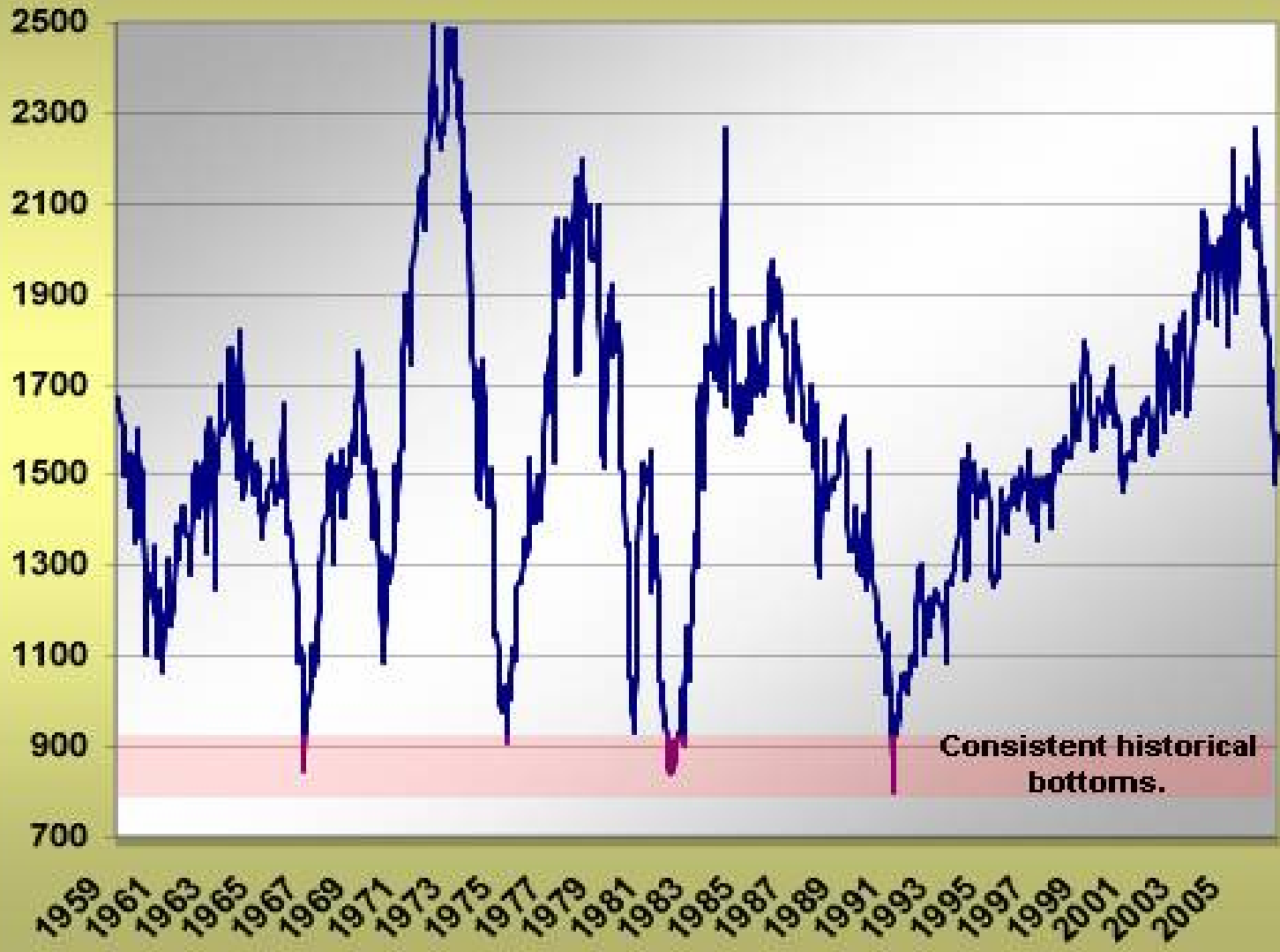
## Bank Credit Standards\*

*Last Point 1Q 2007: 16.4%*



\* Net percentage of banks tightening credit standards for mortgages to individuals  
Source: Federal Reserve

## Housing Starts (000)

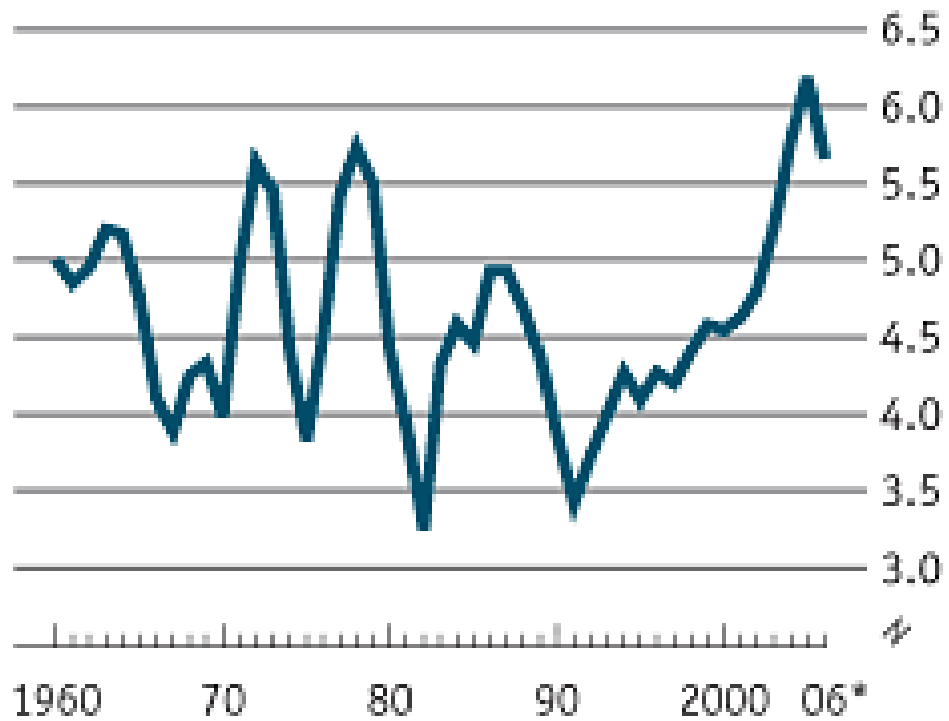


# Macroeconomic Impact of Housing Downturn

- Housing downturn affects economy directly through its impact on residential construction and indirectly through its effect on household savings decisions
- Direct impact of a 35 percent downturn in housing could reduce GDP by around 2 percentage points
- The greater impact of a housing slump could be through its indirect effect on household savings behavior
- Defaults on housing loans could cause problems in the financial sector
- The extent of the overall slowing in the economy will be importantly influenced by Federal Reserve cuts interest rates

## Keeping the home fires burning

US residential construction as % of GDP



Source: US Bureau of Economic Analysis

\*Q3